appropriate rate of return for cost-of-service showings. For all of these reasons, the Commission's cost of equity determination fails to reflect risks and uncertainties accompanying cable equity investments.

3. The Commission's Assumptions Regarding The Cost of Debt Are Also Flawed

The Commission concludes that "8.5% represents a reasonable estimate of the cost of debt for cable." Report and Order at ¶ 190. The Commission noted that that rate "reflects[s] historical debt costs." but, as the EI study shows, the Commission's determination is unsupportable:

> The Commission's discussion . . . displays confusion between short-term working capital costs and long-term debt costs. The Commission's discussion also displays confusion between yield and interest payments. By the Commission's reasoning, if cable firms issued zero-coupon bonds (bonds that have no periodic interest payment), the cost of debt would be zero. . . . The Commission need not speculate on this point. Information on the yield of various grades of debt is widely available. As it did with the cost of equity, the Commission underestimates the cost of debt to the cable industry.[105]

4. The Use of A Uniform Rate of Return for the Diverse Cable Industry Is Inappropriate

Finally, imposition of a uniform rate of return simply is inappropriate for the diverse cable industry. The Commission concluded that "the burdens of establishing an individualized rate of return for each cable operator that elects cost-of-service regulation would be substantial," and that it was "not persuaded that it is necessary to ensure that cable operators can attract the

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[105] Attachment E at 7.

capital needed to provide regulated cable service."[106] This is an unacceptable result, even taking into account the Commission's statement that, in individual cases, parties may seek rates of return different from the prescribed rate.[107]

The Commission should revisit its conclusion in this regard when adopting permanent cost-of-service rules. There are more than 11,000 cable systems in this country. They differ in size, channel capacity, subscriber density, age, and the level of competition they face. Some are publicly-held and some are privately-held. They are in urban, suburban and rural areas; there are large and small systems, independently-owned as well as systems part of an MSO. Given these differences, the prescription of a uniform rate of return for all systems' cost-of-service showings is untenable.

For these reasons, the Commission should permit each cable system to demonstrate the rate of return appropriate for its circumstances based on its financial condition.[108] Rather than imposing a "heavy burden" on an operator to show as-yet-undefined "exceptional facts and circumstances" -- the current showing required to permit use of an individualized rate of return -- the Commission should allow a cable operator to present its own cost of debt and

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[106] Report and Order at ¶ 154.

[107] Id. at ¶ 156. The option to demonstrate a different rate of return may well be illusory given the Commission's conclusion that parties seeking to make such a showing bear a heavy burden, including a showing of "exceptional facts and circumstances." Id. at n.327.

[108] Moreover, as Comcast has observed in its Reconsideration Petition, "because cable relies on shorter-term debt financing than is common in the telephone business, the cost of capital, and thus the minimum required return, for a cable company can change significantly in a short period of time. Any rate of return prescription for the cable industry is likely to be obsolete by the time it is actually applied in a rate case." Comcast Petition at n.31.

preferred stock to determine its own embedded cost and to analyze the cost of equity for its own particular system. Under these circumstances, a generic rate of return (although higher than 11.25%) can be preserved as a default rate for those systems which do not wish to present the data necessary to determine their individual cost of capital.

IV. THE COMMISSION MUST PERMIT CABLE OPERATORS TO ADOPT ACCOUNTING SYSTEMS BEST SUITED FOR THEIR INDIVIDUAL NEEDS

In the Report and Order, the Commission decided to establish a uniform accounting system for cable operators that elect cost-of-service regulation. It adopted interim summary level account requirements for cable operators in general and small cable operators in particular.[109] As part of its Further Notice, the Commission sought comment on a permanent cable uniform system of accounts, set out in Appendix C of the Further Notice. Further Notice at ¶ 307. The proposed USOA is based upon the USOA for Class B telephone companies contained in Part 32 of the Commission's Rules. 47 C.F.R. § 32.11.

In proposing a cable uniform accounting system drawn from its telephone regulatory regime, the Commission maintained that Part 32 "was designed as a functional accounting system that would be adaptable to changes in communications technology." Further Notice at ¶ 307. The FCC "tentatively conclude[d]" that it could "accommodate the cable technology of signal transport by adding certain cable specific accounts and by modifying

[109] Report and Order at ¶¶ 209-225.

account definitions to include cable-specific equipment and activities within existing functions." Id.

In the Report and Order, the Commission limited the application of its accounting requirements to cable operators who elect cost-of-service regulation. Report and Order at ¶ 218. The Further Notice sought comment on whether smaller cable systems that elect cost-of-service regulation should be required to maintain their books in accordance with the accounting system ultimately adopted for cable or with some alternative system of accounts. Further Notice at ¶ 308. It also sought comment on whether cable operators seeking rate adjustments due to changes in their external costs under the benchmark/price cap approach should also be required to maintain their books according to a cable USOA. Id.

The Commission recognized that its proposed cable USOA was merely a "starting point for development of a uniform accounting system for cable operators." Id. at ¶ 306. Indeed, it indicated that it expected the staff of the Cable Services Bureau to hold informal meetings with representatives of the cable industry and other interested parties in addition to analyzing the comments in this proceeding. Following those meetings and the initial comment cycle, the Commission indicated it may seek comment on a more refined and revised cable USOA proposal. Id.

The NCTA Accounting Committee[110] has been examining the proposed USOA set out in Appendix C of the Further Notice. Given the press of other

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[110] The NCTA Accounting Committee is an organization comprised of cable industry financial professionals which provides a forum for sharing information on current and emerging financial and accounting issues and management practices within the cable television industry.

deadlines arising from the Commission's recent rate regulation orders, the Committee members have not had an opportunity to complete a detailed response to and recommendations on the proposed USOA. However, NCTA does expect to take part in the informal meeting sessions with FCC staff described in the Further Notice as well as comment in the reply round in this pleading cycle and in subsequent cycles regarding the proposed USOA.

At this stage, however, a few preliminary observations are appropriate. First, the entire proposal for a cable USOA should be reconsidered. As NCTA demonstrated in the earlier stages of this proceeding, the Commission should not adopt a USOA for cable, but rather should permit cable operators to maintain their books in accordance with Generally Accepted Accounting Principles ("GAAP"). In preparing a USOA for cable, the Commission gave short shrift to the administrative burden that cable operators would endure to modify and then maintain their accounting systems in accordance with a Commission-prescribed USOA.

As NCTA pointed out in its earlier comments, the cable industry does not maintain a uniform accounting system.[111] Even with the most expeditious of proceedings, it is doubtful whether a cable USOA can be put in place in time to serve the purpose driving the proposal in the Further Notice, i.e. to provide uniformity and accurate information to regulators evaluating operators' cost-of-service showings.[112] As has been noted in a Petition for Reconsideration of the Commission's Report and Order:

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[111] See NCTA Comments at 39.

[112] In fact, there is no reason to believe that the industry's current methods of maintaining their accounts would not serve the overriding purpose of providing the relevant regulator with accurate information about the assets, revenues and expenses of the particular system it is examining.

> It is unlikely that a uniform accounting system for cable could be adopted and implemented in time for the cost of service cases that will arise in the first five years under regulation. The large effort on the part of the industry and the Commission that devising this accounting system will require will most likely be undertaken in vain, because most of the cases will be decided before it is in place.[113]

Moreover, the Commission's attempt to shoe-horn the previously unregulated cable industry's accounting methodology into that developed over many years for the telephone industry simply will not withstand scrutiny. Putting aside the facts that Congress has mandated that cable is not to be regulated as a common carrier,[114] and that Chairman Hundt, Commissioner Quello and others have recently emphasized that cable is not to be subjected to a public utility regulatory regime,[115] the idea that the telephone-based Part 32 USOA is appropriate for cable is misplaced.

Indeed, in putting out for comment its USOA proposal, the Commission has ignored the disparate nature of the cable industry: Large and small systems, privately and publicly-held companies, "cable-only" companies and companies with a number of businesses. Unlike the case with

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113 Comcast Petition at 22.

114 See Section 621 of the Communications Act, 47 U.S.C. §621. In a related area, Congress specifically instructed the Commission that it was not its "intention to replicate Title II regulation" and that the FCC should avoid "creating a cable equivalent of a common carrier 'cost allocation manual'." H.R. Rep. No. 102-628, 102d Cong. 2d. Sess. 83 (1992). It is also of more than passing interest that the Commission was given no explicit authority to impose a USOA on cable, unlike the case with its regulatory mandate for telephone company regulation where it was authorized by Congress to "prescribe the forms of any and all accounts, records and memoranda to be kept by carriers subject to this Act...." 47 U.S.C. § 220.

115 Hundt Speech at 7; Quello Statement at 2.

most of the telephone industry, there are fundamental differences in the structure, management and reporting requirements among cable operators. These different companies have significantly different accounting and capitalization policies, as well as financial agendas. One system simply does not fit all.

Second, assuming the Commission is not inclined to revisit its general conclusion that some type of uniform accounting system is required for cable systems electing cost-of-service regulation, it must provide all operators with sufficient flexibility to accommodate their traditional method of keeping their books with any system adopted by the FCC. In this regard, the majority of cable operators have historically accounted for their costs on a functional basis, i.e. Engineering, Marketing, Customer Service, Human Resources, Programming, etc. Most would like to continue to maintain their own internal accounts. The major problem with the proposed USOA is that the proposed expense categorization is not consistent with the industry's predominant functionally-based structure. Accordingly, if the Commission decides to adopt a uniform system for its own use, NCTA urges it to permit operators to leave in place and maintain their current accounting systems and permit those accounts to reference specific FCC-required accounts. Moreover, the FCC should permit summary top level accounts that would allow cable operators flexibility in expense identification.

In the same vein, cable operators should be permitted significant flexibility to account for their non-regulated businesses in their accounts. Unless such flexibility is permitted, it could lead to unnecessary splitting of operations into regulated and non-regulated operations placing additional burdens on the industry and costs to the customers they serve.

Third, in no event should the Commission require cable operators who do not opt for cost-of-service regulation to maintain their books according to a uniform system prescribed by the FCC. To require that cable operators who seek to adjust their rates for external costs employ the proposed USOA would impose on virtually every cable system subject to rate regulation an administrative burden not commensurate with the purported benefits of such a system. The Commission advanced no sound reason for extending any USOA requirement to benchmark/price cap systems and there is none. To the contrary, the Commission correctly concluded in the Report and Order that "it is unnecessary to require uniform accounting under the benchmark/price cap approach." Report and Order at ¶ 218.[116]

Fourth, consistent with the congressional mandate to reduce the administrative burdens on small systems, the Commission should reject the notion that small systems should be required to maintain their books according to an FCC-prescribed cable USOA. Indeed, the interim summary level accounting system adopted for small operators (32 accounts) is hardly less burdensome than that adopted for larger cable operators (55 accounts). Therefore, the Commission should conclude that small systems need not keep their books in accordance with any FCC-imposed USOA, summary level or otherwise, but may continue to maintain their accounts according to GAAP. For purposes of this exemption, eligible small systems should, at a minimum,

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[116] For many systems, this may well be a moot point. As a practical matter, as Comcast points out in its reconsideration petition, "[i]t is not feasible for cable operators that are parts of larger organizations to create new accounting systems for only those systems that must use cost-of-service to justify rates. All systems would have to be converted to the new accounts." Comcast Petition at 22 (emphasis in original).

include independent small systems or a group of small systems owned by a multiple system operator meeting the eligibility requirements adopted for other forms of small system administrative relief.[117] Indeed, given the burden that adopting a USOA would entail, the eligibility requirements should permit even larger "small" systems to be exempt from such a requirement.

V. IN ADOPTING A PERMANENT UPGRADE INCENTIVE PLAN, THE COMMISSION SHOULD AFFORD CABLE OPERATORS MAXIMUM FLEXIBILITY

In the Report and Order the Commission adopted an experimental Upgrade Incentive Plan. Report and Order at ¶¶ 295-304. The plan has the laudable goal of "encourag[ing] cable operators to provide additional services and improve the quality of service, while reducing regulatory burdens." Id. at 295.

The Commission indicated that, under its approach, the regulatory burdens on both cable operators and regulators would be reduced. It observed that it would "ordinarily expect to review only whether the operator is continuing to offer existing services at rates no higher and quality no lower than the operators contracted to provide. We would not expect to investigate complaints regarding rates for additional regulated services unless they were clearly outside a wide range of reasonable rates, as evidenced, for example, by similar systems." Id. at ¶ 299.

The Commission stated that, in order to gain experience with this approach, it would consider proposals from cable operators on a case-by-case

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[117] See e.g. Report and Order at ¶ 223 and n. 436 (small system accounting requirements).

basis, asking operators to submit proposals to the Cable Services Bureau accompanied by a written statement from any certified franchising authority with jurisdiction over the cable systems affected by the plan discussing the authority's view of the proposal. Id. at ¶ 304.

The Commission's experimental Upgrade Incentive Plan is in its embryonic stages. While NCTA applauds the Commission's effort to provide incentives for system upgrades, we believe it is premature to discuss, let alone adopt, rigid rules for a permanent Upgrade Incentive Plan while the experimental plan is still being developed.

Nevertheless, the Further Notice proposes that a permanent plan be adopted and seeks comment on a number of other issues including:

- Whether cable systems should be required to "enroll" in advance of any system upgrade in order to take advantage of the plan;

- Whether an operator should be required to commit to maintaining its basic service tier rates and quality within benchmark/price cap guidelines set by a certified franchising authority in order to avoid potential shifting of costs to the basic tier; and

- How to assure that operators subject to the incentive plan provide services equal to or better than those offered under current rates applicable to those services.[118]

NCTA urges the Commission to defer consideration of hard-and-fast rules for any permanent plan until it has had sufficient experience with the experimental plan currently in force. Consideration of rigid rules -- let alone their adoption in the early phase of cable rate regulation -- may well stifle

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[118] Further Notice at ¶¶ 325-329.

the creativity that will emerge from the reaction of the FCC and local regulators to experimental plans proposed by cable operators.

At the same time, the benefits accorded cable operators should not be illusory. Those operators proposing an experimental upgrade plan should be given every assurance that their proposals (particularly if submitted with the concurrence of their franchising authority) will be acceptable to the Commission. If this were not the case, incentives for upgrading systems would be significantly reduced, if not eliminated.

Indeed, as the experimental plan stands now, there are substantial disincentives to seek Commission approval of upgrade proposals. For example, an operator can achieve the pricing flexibility purportedly offered by the experimental plan by adding its proposed new services to an unregulated tier. There is little incentive for an operator to run the gauntlet of FCC (and local) approval and supervision for five years in exchange for pricing flexibility achievable without accepting such burdens. Moreover, it is unrealistic to expect any operator to accept a freeze on its existing offerings for five years or more in the face of the competition now facing the cable industry.

Despite these problems with the plan, we believe it is a sincere effort to accommodate what the Commission recognizes as legitimate industry and consumer concerns. And, to be sure, eventually rules must be adopted in order for all interested parties to operate with consistent expectations. However, at this early stage, NCTA believes that the Commission should afford significant flexibility in allowing operators to prepare, propose and implement experimental upgrade incentive plan proposals. For this reason, the Commission should defer consideration -- and adoption -- of rules for a permanent Upgrade Incentive Plan. Instead, once it has had an opportunity to examine various operator proposals -- and observe how they work in practice -- the Commission should then issue a rulemaking notice based on the actual operation of the experimental plans. Until that time, consideration of rules for a permanent plan would not be a wise use of the Commission's limited resources.

VI. TO THE EXTENT AVERAGE COST SCHEDULES CAN BE DEVELOPED, THEIR USE SHOULD BE OPTIONAL

The Commission has stated that it would soon initiate a number of industry-wide cost studies which will not only be used in determining whether any changes should be made in its interim cost-of-service regime but also would be used to determine what further steps to take, if any, with small systems and low price systems subject to transitional relief which were not required to reduce their rates to the full reduction rate.[119] Chairman Hundt has made clear that the purpose of these studies is to obtain a more "accurate picture of the cable industry." He rejected the suggestion that the cost studies were "a tactic to permit a further reduction of the competitive differential." As he said emphatically: "To anyone who has entertained this suspicion, let me clearly and unequivocally disabuse you of that idea. I know of no evidence to support a further reduction of the competitive differential and we are not looking for such evidence."[120]

One area where the proposed cost studies may be useful is in developing average cost schedules for use in setting rates for regulated equipment and cable service. Under such an approach -- used for some

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[119] Further Notice at ¶ 334.

[120] Hundt Speech at 8.

telephone companies -- rates would be set by reference to average cost not by reference to the individual operator's costs. In proposing the use of average cost schedules, the Commission sought comment on whether they should be available for all operators or only small systems. It also sought comment on the eligibility criteria for small systems if the use of average cost schedules were to be restricted to "small systems."[121]

The differences in the 11,000 cable systems in the country may well be greater than their similarities, making it difficult, if not impossible, to graft a telephone company-like average cost schedule regime onto the wholly distinct cable industry. Nevertheless, NCTA does not oppose the use of average cost schedules in cable rate-making proceedings so long as their use is not mandatory. Every cable operator should have the opportunity to justify its rates based on its own unique circumstances. Mandating the use of average cost schedules would deny cable operators their right to justify their rates based on their particular costs, rendering the cost-of-service option meaningless.[122]

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[121] Further Notice at ¶¶ 330-333.

[122] The Commission must recognize that gathering data from every cable system in the country on some type of uniform basis and thereafter developing average cost schedules for the cable industry will be a monumental task. As an alternative, the Commission might consider making use of the cost data which will be submitted to it in the Form 1220's and 1225's filed by those cable operators seeking to justify their rates on a cost-of-service basis supplemented by data from a randomly-selected group of other operators. With appropriate masking of identifying information, this data could be released for comment and analysis, and eventual use in average cost schedules. Such an approach would reduce the burdens on the industry as a whole as well as on the Commission and may serve at least as a starting-point for determining whether cable average cost schedules are a realistic possibility.

Assuming the use of average cost schedules is optional, the option should be made available to all systems, regardless of size. To the extent it is found that the available information is insufficient to develop average cost schedules for systems of all sizes, the Commission should make the best use it can of the data it gathers and establish reasonable categories -- by cable system size -- for average cost schedules, without limiting the use of such schedules to systems of a particular size.

VII. THE COMMISSION SHOULD REJECT ANY PROPOSAL TO MODEL CABLE AFFILIATE TRANSACTION RULES ON SIMILAR RULES FOR THE TELEPHONE INDUSTRY

In the Report and Order, the Commission adopted affiliate transaction requirements to govern determination of costs incurred that can be recovered in rates for regulated cable service. Report and Order at ¶¶ 249-271. The rules adopted by the Commission apply to cable operators electing cost-of-service regulation or those seeking to adjust benchmark/price cap rates for affiliated programming costs. The rules themselves mirrored affiliate transaction rules applicable to telephone companies and generally require valuation of affiliate transactions at the asset provider's prevailing company price.

As NCTA demonstrated in the initial stage of this proceeding,[123] there is no need to regulate affiliate transactions in the cable environment. Unlike the case with the telephone industry, there is no history of cross-subsidization by vertically-integrated affiliates in the cable industry. Apart from programming, cable operators do not generally have affiliated vendors of equipment and related items. As for programming, as NCTA observed,

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[123] NCTA Comments at 42.

any abuse of affiliated programming costs would be easily detectable in a cost-of-service showing.

Despite this well-documented argument, the Commission adopted the affiliate transaction rules described above. Now the Commission proposes to modify in a significant way the affiliate transaction rules it just adopted. The impetus for this change is the fact that the Commission is now re-examining the current affiliate transaction rules for telephone companies upon which it based its cable rules. As a result, the Commission proposed to limit the application of the prevailing company price as a measure of a reasonable price for an affiliate transaction. It tentatively concluded that it would "not permit prevailing company pricing as a valuation method for transactions between cable operators and their affiliates when a primary purpose of the non-cable affiliate in transactions is to serve the cable operator and its affiliates." Further Notice at ¶ 310.

The "primary purpose" test would be based on the percentage of each non-cable affiliate's total output that is sold to non-affiliates. Under the Commission's proposal, prevailing company pricing would only be permissible for affiliate transactions in which the non-cable affiliate sells at least 75 percent of its output to non-affiliates. If transactions do not meet the prevailing company price test, cable operators would have to value all affiliate transactions at the higher of cost and estimated fair market value when the cable operator is the seller, and at the lower of cost and estimated fair market value when the cable operator is the purchaser. Id. at ¶ 312.

Given the strict standard for determining whether entities are "affiliates" -- five percent or greater ownership interest[124] -- the Commission's proposed rules could have significant negative effects on the cable industry, as numerous transactions would have to be valued at cost when, in fact, a fair market value does exist which is much higher than cost. Moreover, the cable industry has had no opportunity to operate under the recently-adopted affiliate transaction rules which -- whether warranted or not -- should at least serve the Commission's purpose in adopting such rules, i.e. to limit cross-subsidy abuses. To significantly revise those rules before the industry and the Commission have gained any experience under them would be unwise.

In addition, given the fact that there has been absolutely no demonstration in the cable industry of the type of cross-subsidization against which the current telephone affiliate transaction rules are directed, there was no need to impose similar rules on the cable industry, let alone to require compliance with the proposed new telco rules which, in effect, create an unrebuttable presumption that affiliate transactions will not be valued properly. Whatever the case may be in the telephone industry, there is no justification for adopting identical rules for cable merely because they are being considered for the telephone industry. Indeed, given the admonition in the Communications Act that cable is not to be regulated as a common carrier and the statements made in conjunction with the adoption of 1992 Act that cable should not be regulated like a utility, it is inappropriate -- if

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[124] Further Notice at ¶ 313 and n. 577.

not unlawful -- to impose telco-oriented affiliate transaction rules on an industry which has none of the abuses to which those rules are addressed.

Finally, as Discovery Communications, Inc. ("Discovery") has advised the Commission, there are strong public policy reasons why telco-like affiliate transaction rules should not be applied to the cable industry:

> [C]able operators historically have, to a significant degree, provided crucial financial support to programmers at critical times in their development. On numerous occasions, cable operators contributed much-needed financing to ensure the viability of a program service.
>
> Discovery's own existence is a prime example of this phenomenon. . . . [W]ithout the financial support of several cable operators, it is unlikely that Discovery would have evolved into the highly acclaimed service that it is today. Other programmers similarly owe their current existence to financial support from cable operators.[125]

For these reasons, the Commission should reject the proposal to modify its recently-adopted prevailing company pricing methodology for cable affiliate transactions, and, indeed, should revisit its decision to apply any telco-derived affiliate transaction rules to the cable industry.

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[125] See Discovery Communications, Inc., Opposition to Petition of Bell Atlantic for Further Reconsideration, MM Docket No. 93-215, filed June 16, 1994, at 5-6.

CONCLUSION

For the reasons stated above, the Commission should:

- Promptly release an order withdrawing the proposed productivity offset from further consideration;

- Substantially revise its cost-of-service interim rules, particularly with respect to its original cost valuation methodology, its treatment of so-called "excess acquisition" costs, start-up losses beyond the first two years and certain intangibles and its proposed 11.25% rate of return;

- Reject the notion that a USOA is necessary for the cable industry or, in any event, permit cable operators significant flexibility in ordering their business operations while operating with a USOA; but in any event, continue discussions with the cable industry and other interested parties on refining the telco-oriented proposed USOA looking toward issuance of a Second Further Notice of Rulemaking is CS Docket No. 94-28 seeking comment on a more focused, cable-oriented approach.

- Defer consideration of a Permanent Upgrade Incentive Plan until it gains experience under its newly-adopted Experimental Upgrade Incentive Plan;

- Proceed to develop average cost schedules for use by all categories of cable systems for which data is available as long as the use of average cost schedules for rate-making purposes is optional, not mandatory; and

- Reject the proposal to mimic the proposed telco affiliate transaction rules because the cross-subsidization concerns underlying those rules have no applicability to the cable industry and adoption of such rules would be contrary to the public interest.

Respectfully submitted,

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July 1, 1994

ATTACHMENT A

"Why the Commission Should Not
Adopt a Productivity Offset"

Economists Incorporated
August, 1993

(originally submitted as Appendix C to
NCTA Comments in MM Docket No. 93-215)

APPENDIX C

Why the Commission Should Not Adopt a Productivity Offset

I. Introduction

The Commission has solicited comments on whether "productivity offsets" should be applied under cable rate regulation and whether there is a valid economic basis to assume that "cable service has been, and will be, experiencing efficiency gains."[1] In particular, the Commission solicited comments on four options as productivity offsets: "(1) no productivity offset; (2) a consumer productivity dividend of 0.5 percentage points; (3) a telecommunications industry adjustment between 3.0 (AT&T) and 3.3 (local exchange carriers) percentage points; and (4) a different productivity offset for cable operators."[2]

For several reasons, we find that there is no economic basis to have a productivity offset for the cable industry. First, two of the candidates for measures of productivity offsets are drawn from rate regulation of the telephone industry.[3] While there may be a reasonable basis for applying a productivity offset in the Commission's rate regulation of the telephone industry, neither the Commission's form of regulation of the cable television industry nor the industry itself is amenable to a productivity offset.

Second, there are no government-maintained measures of productivity growth for the cable television industry. Any productivity measures must rely on special industry studies.

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1 FCC, "Notice of Proposed Rulemaking," MM Docket No. 93-215, July 15, 1993, Paragraph 85.

2 Ibid.

3 The adjustments of 3.0 for AT&T and 3.3 for local exchanges are based on FCC, "Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order," CC Docket 87-313, September 19, 1990. The 0.5 percentage point productivity dividend was implemented to ensure that some of the efficiency gains realized in moving from cost-of-service regulation to rate caps was passed through to customers. No "efficiency dividend" will result from imposing regulation on cable systems.

Third, productivity measures for the cable industry must account for rapid improvements in the quality of programming and service. Productivity improvements result in reduced costs, whereas programming and service quality improvements tend to increase costs. Cable operators have substantially improved the quality of service as well as improved operational efficiency. Historically, the effects of quality improvements on costs have more than offset the effects of efficiency improvements.

Fourth, reduction of annual inflation increases by productivity offsets is unwarranted based on recent experience with changes in competitive cable rates. Simple adjustments for inflation based on the GNP-PI index applied to the benchmark tables do not account for the quality-based and cost-based increases in service rates for the "competitive" systems between 1986 and 1992. To accommodate these quality-based cost increases for competitive systems would require an allowance for price increases above the GNP-PI index of nearly 5 percent per year per subscriber channel. Although some of the price increases may reflect costs that could be passed directly to subscribers under the benchmark rate regulations,[4] other portions of the price increases may reflect costs that could not be passed directly to subscribers. The Commission should not consider reducing the annual rate adjustment based on the GNP-PI for productivity improvements alone without an even greater adjustment for price increases to reflect quality improvements.

Fifth, even if a measure of historical cable industry productivity were available, it is impossible to predict whether that rate would continue in the future, particularly under a new regulatory environment. The rate of productivity improvement in the industry is likely to decline under rate regulation.

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4 Increases in programming costs and costs associated with public, educational, and governmental channels account for some of this price change. These increased programming costs would be passed through to consumers under the benchmark regulation. FCC, "Report and Order and Further Notice of Proposed Rulemaking, MM Docket 92-266, April 1, 1993, paragraphs 251-252.

For all of the above reasons, simply using the GNP-PI without any other adjustments for annual price changes of the benchmark tables is a conservative measure that is likely to favor consumers.

The Notice suggested comparing a system's rates per channel today to its inflation-adjusted rates per channel in 1986 as an alternative safe harbor to the benchmark rate structure.[5] If the Commission adopts this safe harbor alternative, it would be inappropriate to reduce the inflation adjustments by productivity offsets without allowing adjustments for the additional costs of programming and service quality improvements. These latter adjustments may be greater than any productivity adjustment.

II. Productivity and price regulation for the cable industry are different from those for the telephone industry

The Commission has applied productivity offsets in the rate regulation of the telephone industry. In 1990, the Commission determined that regulated telephone companies were becoming increasingly efficient at providing regulated services; as a result, these services were becoming less costly in real terms.[6] Consequently, rather than allow regulated rate caps to increase annually by an unadjusted general measure of inflation such as GNP-PI, the Commission decided to reduce the allowed annual rate of price increases under price caps by a "productivity offset," 3 percent for AT&T and 3.3 percent for local exchanges.[7]

The productivity offset for regulated prices of telephone services was applied under the following circumstances: (1) well-defined measures of

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5 FCC, "Notice of Proposed Rulemaking," MM Docket No. 93-215, July 15, 1993, Paragraph 71.

6 FCC, "Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order," CC Docket 87-313, September 19, 1990.

7 Ibid. These productivity offsets were based in part on historical rates of price reductions under cost-of-service regulation and an assumed 0.5 percent consumer productivity dividend with greater efficiency incentives under price caps.

service output or service efficiency;[8] (2) uniform quality associated with service;[9] (3) easily documented price trends;[10] (4) price trends that clearly indicated falling prices;[11] (5) easily available corroborating measures of productivity improvements;[12] and (6) movement from rigid federal cost-of-service regulation to a more flexible form of price cap regulation.[13] None of these six characteristics applies to the cable industry, and consequently, there is no economic basis to assume that a productivity offset should apply to the cable industry.

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8 For measures of output or efficiency for regulated telephone service, see FCC, "Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order," CC Docket 87-313, Sept. 19, 1990, Appendix C and Appendix D. In contrast, measures of output or efficiency for cable operators are more elusive. The FCC has implicitly selected basic channels per subscriber as the measure of output and regulated revenue per subscriber channel as the measure of efficiency, but other measures might equally well have been selected. Differences in quality confound the measurement of either output or efficiency for the cable industry. See Section V.

9 Quality of regulated telephone service is relatively constant across providers and over time. In contrast, quality of service (for example, the number of channels, the number and variety of satellite networks, the probability of a service interruption, two-way addressability, and levels of customer service) varies substantially among cable operators. Moreover, differences in local regulation of access for public, educational, and governmental channels lead to differences in quality of service for local interests. Finally, quality of service for cable television changes rapidly from year to year. See Section V.

10 When price caps were adopted in 1990, the FCC had previously regulated certain rates for AT&T and local exchanges for decades. Information on prices and even costs were readily available. In contrast, the FCC has never regulated rates for cable operators. Interpretation of historical rate information, where available, is confounded by changes in programming quality and local regulation.

11 Information available to the FCC in 1990 on regulated telephone rates clearly indicated that real prices were falling over time. FCC, "Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order," CC Docket 87-313, Sept. 19, 1990, Appendix C and Appendix D. A reasonable argument could be made for a productivity offset under these circumstances. In contrast, applying the benchmark rate formula to the Commission's cable rate survey data for 1986 indicates that real competitive prices for cable services have increased rather than fallen holding the number of channels and satellite networks constant. See Section V. A productivity offset does not make sense under these circumstances.

12 In 1990, the FCC could have referred to BLS measures of productivity improvements to reach a conclusion of productivity improvements in the telephone industry. No such government-sponsored productivity measures are available for the cable industry. See Section III.

13 See Section VI.

III. There are no government-sponsored measures of productivity for the cable television industry

The Commission recognizes the difficulty of measuring productivity improvements for the cable television industry.[14] There simply are not any available measures of industry productivity growth. Neither the Bureau of Labor Statistics (BLS) nor any other government agency calculates any productivity indexes for cable television operators or related industries.[15]

Cable operators are part of Standard Industrial Classification (SIC) industry number 4841, a broad industry classification that also includes closed circuit television services, direct broadcast television services, multi-point distribution services, and satellite master antenna systems services.[16] BLS does not maintain a productivity series for SIC industry 4841, but does maintain a labor productivity index for SIC industry group 481, telephone communications.[17] It is the only industry group within the communications sector of the economy for which government-sponsored productivity indexes are maintained. SIC group 481 includes not only local exchanges and long-distance phone companies but also cellular phone companies and paging services.

There is no reason to expect that the productivity series for SIC group 481 would be an accurate indicator of productivity changes for a specialized

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14 FCC, "Notice of Proposed Rulemaking," MM Docket No. 93-215, July 15, 1993, Paragraphs 83-85.

15 Department of Labor, Bureau of Labor Statistics, *Productivity Measures for Selected Industries and Government Services*, April 1993.

16 Executive Office of the President, Office of Management and Budget, *Standard Industrial Classification Manual, 1987*, Washington, DC: GPO.

17 Labor productivity is an inaccurate indicator of industry efficiency. It is measured as the ratio of output to hours of direct employment. It is subject to volatility in measurement because different types of labor are counted differently. A simple shift of labor from direct employment to a subcontracting agency changes the measure of labor productivity without changing the technical operations of a cable system. Labor productivity is also subject to substitution effects between labor and other factor inputs as relative factor prices shift.